

M e m o r a n d u m

To : Ms. Cynthia Bridges
Executive Director (MIC 73)

Date: April 1, 2014

From : Jeffrey L. McGuire, Deputy Director
Sales and Use Tax Department (MIC 43)

Subject : **Board Meeting April 22-24, 2014**
Item N: Administrative Agenda
Proposed Revision to Audit Manual
Chapter 4, General Audit Procedures

In accordance with the established procedures for audit and compliance manual revisions, I am submitting proposed new Audit Manual (AM) section 0421.00, *Audit of Nontaxable Electronic Sales and Purchases of Computer Software* (Exhibit 1).

The proposed AM section was initially reviewed and approved by SUTD management, provided to Board Members, and posted at <http://www.boe.ca.gov/sutax/pmr.htm> to solicit comments from interested parties. Staff received submissions from two interested parties during the 60-day comment period. Staff revised the proposed language to address the interested parties concerns (See Exhibit 2). The revised proposed language has been reviewed and approved by SUTD management and the Legal Department.

The proposed AM section, inclusive of the revisions, is attached for your reference. We request your approval to forward it to the Board Proceedings Division for placement on the Administrative Agenda as a consent item at the April 2014 meeting.

If you have any questions, please contact me or Ms. Susanne Buehler at 324-1825.

JLM:rsw

Attachments

Approved:

STATE BOARD OF EQUALIZATION



BOARD APPROVED

At the April 22, 2014 Board Meeting

Joann Richmond
Joann Richmond, Chief
Board Proceedings Division

Cynthia Bridges
Ms. Cynthia Bridges
Executive Director

cc: (all with attachments)

Mr. Randy Ferris (MIC 83)

Mr. Robert Tucker (MIC 82)

Mr. Wayne Mashihara (MIC 46)

Mr. Kevin Hanks (MIC 49)

Ms. Susanne Buehler (MIC 92)

AUDIT OF NONTAXABLE ELECTRONIC SALES AND PURCHASES OF COMPUTER SOFTWARE

0421.00

INTRODUCTION

0421.01

This section provides guidance regarding the uniform documentation standards and audit procedures to be used in the verification of claimed nontaxable sales and purchases of electronically transferred computer software, including software electronically transferred pursuant to a software maintenance contract, and software transferred by the “load and leave” process.

Please note: When sales and purchases of electronically transferred software do not include the transfer of tangible personal property, the Technology Transfer Agreement provisions of the Revenue and Taxation Code do not apply.

Sales of prewritten software and software maintenance contracts are not taxable transactions if the seller transfers the software via:

- (1) Remote telecommunications to the purchaser’s computer; or
- (2) Installation of the software directly into the permanent storage memory of the customer’s computer, unless the installation is part of the sale of the computer.

In both cases, in order for tax not to apply, no tangible personal property, such as storage media, may be transferred in the transaction.

Software or periodic software upgrades or updates may be electronically transferred directly to a purchaser’s computer over the Internet, or by a “load and leave” process.

SOFTWARE TRANSFERRED BY A LOAD-AND-LEAVE PROCESS

0421.02

A sale of software by the load-and-leave process requires the seller, the seller’s employee, or the seller’s agent to personally install the software directly into the permanent storage memory of the customer’s computer and requires that the installation is not part of the sale of the computer. When software is transferred via load-and-leave, the seller or seller’s agent must retain title and possession of the storage media containing the software during the entire installation process. Any transfer of title or possession of the storage media containing the software to the purchaser, however temporary, will render the transaction taxable. During the load-and-leave process, the period of time the seller’s storage media is connected to the customer’s computer is not considered a temporary transfer provided that the seller or seller’s agent maintains control of the loading process and retains title to and possession of the storage media/device at all times.

**SALES AND PURCHASES OF SOFTWARE TRANSFERRED
ELECTRONICALLY**

0421.03

Sales and purchases of software transferred electronically are not subject to tax if no tangible personal property is furnished by the seller in the transaction. In cases where tangible personal property is provided in the transaction, in any format except written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program, tax applies to the original electronic transfer of the software, even when the tangible personal property is shipped subsequent to the electronic transfer of the software provided that the transfer of tangible personal property is part of the original sale of the software.

However, where the software is transferred electronically, if another copy of the software is later sold to the purchaser on tangible storage media as part of a separate and distinct transaction, tax will not apply to the prior sale of the electronically supplied copy of the software. Conversely, where the software is transferred on tangible storage media, if another copy of the software is later sold to the purchaser and transferred electronically as part of a separate and distinct transaction, tax will not apply to the subsequent sale of the electronically supplied copy of the software. The determination as to whether a transaction is separate and distinct will be based on the facts and circumstances, and evaluated on a case-by-case basis.

In most cases, electronic delivery of the software will be initiated by customers by going to the seller's website to "pull" a copy of the software to their computers. In those cases, the seller will transmit an access code, or "key," that customers must use to activate the software. *An auditor should be aware that charges for the use of an access code or "key" to "unlock" software programs or features previously transferred on tangible storage media are subject to tax.* Conversely, charges for the use of an access code or "key" to "unlock" software programs or features previously transferred electronically are not subject to tax.

Some software providers may offer a cloud computing service model known as "Software as a Service," in which: (1) customers can access the software on a remote network or location, (2) customers do not receive a copy of the software, electronic or otherwise, and (3) the seller retains possession and control of the software at all times. Under these conditions, tax does not apply to charges for "Software as a Service," or similar models, such as "Platform as a Service" or "Infrastructure as a Service," in which there is not a transfer of title or possession of any tangible personal property in the transaction.

Some sellers may give customers the option of receiving the software either electronically or through the transfer on a tangible storage media. Sellers that provide such an option may maintain separate and distinct product codes, part numbers or stock keeping units (SKU) for the electronic delivery and storage media delivery modes. The seller's billing system should then add or not add sales tax reimbursement or use tax to the sale, depending on whether the product code is for the storage media version or the electronic version. The seller may have multiple software products having different distribution methods associated with

each product. For instance, a particular software product may only be available to customers through electronic delivery, while another may be obtained either electronically or on storage media.

When the sale of prewritten software is a nontaxable transaction, the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge. The transfer of such documentation does not make an otherwise nontaxable electronic transfer of prewritten software subject to tax.

AUDIT PROCEDURES FOR SALES

0421.04

Auditors should be mindful that the prevailing business practice in the software industry is to transfer software electronically without providing a copy of such software on tangible storage media. When reviewing claimed nontaxable sales of electronically transferred software, the auditor should conduct a review of the taxpayer's business practices, policies, procedures, and the company website (if one exists) to gain an understanding of the method(s) used to sell, transfer, or distribute software to its customers.

Staff should accept the taxpayer's claim that its sales of electronically transferred software are nontaxable when staff has conducted preliminary testing (informal spot or random tests) and found that no exceptions exist and staff is satisfied that:

- The taxpayer's policy and common practice is not to transfer a tangible copy of the software to the purchaser,
- There is no documentation to support that such transfers occurred.

Additional "controlled" testing should be conducted when exceptions exist. An auditor should always keep in mind the general auditing procedures and techniques outlined in this chapter, including short tests and cut-off techniques. One way to determine if a customer was provided with a copy of software on tangible storage media is to check for shipping charges. The absence of a charge to the customer for shipping is indicative that the software was shipped electronically. As with other types of sales, large dollar transactions may be stratified for review on an actual basis, as deemed appropriate by the auditor.

Reviewing Individual Transactions

Unless there is affirmative evidence that a copy of the software was furnished on tangible storage media in the transaction (e.g., an invoice shows shipping charges), the auditor should presume the transaction is nontaxable.

Where there is ambiguity or contradictory information/documentation regarding whether a transfer of tangible personal property occurred, the auditor should use appropriate auditing procedures to resolve the issues. The auditor may request copies of shipping documents, billing statements, or other documentation, such as

invoices or purchase orders to determine whether copies of software on tangible storage media were transferred to buyers. If the underlying sales related documentation, such as the contract, purchase order, or other pertinent information supports the taxpayer's claim that the software was delivered electronically, the auditor should accept the taxpayer's claim that the sale was nontaxable. If, after examining the underlying sales related documentation, substantial ambiguity remains, as part of the audit process, the seller may use either BOE-504-CSW (paper version) or Form BOE-504-CSW1 (electronic version) – *Statement Concerning Property Purchased Without Payment Of California Sales Tax - Software*, to support its assertion that a copy of the software or software updates were not transferred to the purchaser on tangible storage media.

An auditor should not conclude that software was transferred on tangible storage media based upon the fact that a sales invoice has the "ship to" address field completed. There may be valid business reasons to include a "ship to" address on the invoice, even though no tangible personal property was actually shipped. For instance, many common billing systems automatically populate the "ship to" field with the same information that is in the "bill to" field if there is no "ship to" address. Additionally, the seller may have its billing system set up to track electronic transfers to states where downloads are subject to tax. A sales invoice with the "ship to" address field completed should not be considered affirmative evidence showing the software was delivered via tangible personal property.

Load-and-Leave Transactions

The seller/buyer may provide any substantive evidence establishing that the software was not transferred on tangible storage media. For instance, consistent with audits of electronically transferred software, the taxpayer may provide evidence regarding its business practices and policies of only providing or receiving certain software without the transfer of storage media to the purchaser. In addition, the absence of a separate charge for storage media is evidence that no such storage media was sold to the purchaser. Although not required, if the parties executed a contemporaneous statement memorializing the facts of the "load and leave" transaction, it should be accepted as "pertinent information" that no tangible storage media was delivered to the purchaser.

A sample contemporaneous statement memorializing the facts of a load and leave transaction may be as follows: "The software program, [name of software program], was loaded on the computer of [purchaser's name] by [seller's employee or seller's agent that installed the program], and [seller's employee or seller's agent] did not transfer any tangible personal property containing the software, such as tangible media, to [purchaser's name]." This is sample language and there is no specific wording that must be included in the statement.

AUDIT PROCEDURES FOR PURCHASES

0421.05

When examining purchases of software, staff should look for evidence indicating a tangible copy of the software was furnished to the purchaser. Because sellers

have a common practice regarding electronically transferred software, staff may presume purchasers of software likewise have a common practice of receiving software electronically, despite the fact purchasers utilize multiple vendors. Unless there is affirmative evidence that a copy of the software was furnished on tangible storage media in the transaction, the auditor should presume the transaction is nontaxable.

Indications that a tangible copy of the software was shipped to the purchaser may include an amount billed for transportation charges in connection with electronically transferred software, or a separately stated charge for storage media.

If the auditor still has questions as to the method of delivery, they may find it helpful to gain insight as to the seller's business practice. One way to do so would be to visit the software vendor's website to see if the vendor makes copies of its software available on disk. Another way is to determine whether the seller has been audited and if so, contact the auditor of the seller.

DONGLES

0421.06

A dongle, which is considered tangible personal property, is a security device used to prevent unauthorized reproduction of software and/or to make the software fully functional. Even in cases where the dongle is "optional," when the dongle is provided as part of the sale of software the seller is deemed to be selling a single item, as the true item sold is software subject to a physical security device without which the software will not function properly.

The inclusion of a dongle in connection with the transfer of software renders the entire transaction to be a taxable sale of tangible personal property. Whether the charge for the dongle is separately stated or not, even if sold subsequent to the transfer of the software under a separate invoice, the charges for the software (unless the software program qualifies as a custom program) and for the dongle are subject to tax. This is true even in cases where the purchaser is not contractually required to purchase the dongle, provided the purchaser must acquire the dongle to operate the software.

ANNUAL SOFTWARE LICENSE RENEWALS

0421.07

Tax generally applies to the gross receipts from the sale of annual software license agreements when the original agreement provides for the delivery of copies of the software on tangible storage media to the buyer. This is true regardless of whether or not upgrades or updates provided through the License Agreement are subsequently transferred electronically. For guidance with respect to upgrades and updates furnished pursuant to optional software maintenance contracts, see Section 0421.08.

In cases where the original software sale is subject to tax, tax applies to annual software license renewals without regard to the length of time which has elapsed or the changes resulting from the upgrades previously provided. Tax applies in the same manner whether there is a single, multi-year agreement or multiple single

year agreements.

However, tax does not apply to the gross receipts from annual software license renewals when the software updates or upgrades are electronically transferred, and the original sale of the software was not taxable because the software was transferred to the licensee electronically and no copies of the software on tangible storage media were furnished with prior updates. Audit procedures, when necessary, should be performed in substantially the same manner as other sales and purchase transactions.

OPTIONAL SOFTWARE MAINTENANCE CONTRACTS

0421.08

A software maintenance contract is an agreement requiring the seller of software to provide the customer with either technical support services or software upgrades and updates, or both. A maintenance contract is optional if the purchaser may purchase the software without also purchasing the maintenance contract. Pursuant to [Regulation 1502\(f\)\(1\)\(C\)](#), tax applies to 50 percent of the lump sum charge for the sale of an optional software maintenance contract, when the updates and upgrades were delivered on tangible storage media. If no tangible personal property is transferred to the purchaser during the term of the maintenance contract, tax does not apply to any portion of the charge.

When an optional software maintenance contract is silent with respect to whether software on tangible storage media is to be transferred, or when the terms of an optional software maintenance contract explicitly provide that no copies of software on tangible storage media will be transferred to the purchaser, the seller is not required to report tax on any portion of the gross receipts from the sale of the optional software maintenance contract (provided that no such copies are in fact transferred).

When the parties of an optional software maintenance contract contemplate a transfer of tangible personal property, and tangible personal property is in fact transferred, tax applies to 50 percent of the lump sum charge for the sale of an optional software maintenance contract. The transaction must be reported on the sales and use tax return for the period in which the transaction occurs. If, in fact, no tangible personal property was transferred to the purchaser during the term of the maintenance contract, the seller may file a claim for refund for the tax remitted on the sale of the maintenance contract. For procedures with respect to the treatment of excess tax reimbursement and supporting a claim for refund, refer to section 0417.00.

Substantiating whether software upgrades and updates under an optional software maintenance contract were delivered electronically or by tangible media is the same as substantiating whether software was delivered electronically.

Below is a summary of the revisions made, or staff's response, to interested parties' comments.

- **Technology Transfer Agreements** – Added sentence to explain that when there is not a transfer of tangible personal property, the technology-transfer-agreement statutes do not apply. (Section 0421.01.)
- **Access Key** – Removed reference that taxpayers should retain email correspondence in which an access key was transferred to the purchaser. (Section 0421.03)
- **Cloud computing** – Clarified that, in addition to "Software as a Service," other cloud computing models such as "Platform as a Service" and "Infrastructure as a Service", are not subject to tax, provided that the transaction does include the transfer of tangible personal property. (Section 0421.03.)
- **Exemption Certificates** – Removed reference to taxpayers retaining "exemption certificates." (Section 0421.04.)
- **Underlying sales related documentation** – Specified that when there is ambiguity regarding whether software was transferred on storage media, staff is instructed that if the underlying sales related documentation, such as the contract, purchase order, or other pertinent documentation supports the taxpayer's claim of electronic transfer, the auditor should accept the transaction as nontaxable. (Section 0421.04.)
- **File Transfer Protocol (FTP) logs** – Removed references to FTP logs, as these records can be extremely burdensome to produce. (Section 0421.04.)
- **Load and Leave** – Specified that for load and leave transactions, taxpayers may provide any substantive evidence establishing software was not transferred on storage media, including a contemporaneous statement memorializing the facts of the transaction. While a sample statement is provided, there is no specific wording required. (Section 0421.04.)
- **Use of BOE-504** – Clarified that the BOE-504 is a form of last resort that may be used during the audit process. Staff also moved the guidance under "Reviewing Individual Transactions" rather than under the section regarding load and leave transactions because the form may apply to both electronic transfers and load and leave transactions. (Section 0421.04.)
- **Audit Procedures for Purchases** – Specified that because sellers have a common practice of transferring software electronically, we may presume purchasers of software likewise have a common practice of receiving software electronically. (Section 0421.05.)
- **Optional Software Maintenance Contracts** – Clarified that when an optional contract is silent, or explicitly provides that software is not to be transferred on storage media, tax does not apply (provided that no such copies are in fact transferred). If the contract contemplates a transfer of software on storage media, and tangible personal property is in

fact transferred, tax applies to 50 percent of the lump sum charge for the optional maintenance contract. (Section 0421.08.)

- **Dongles** – Interested parties offered an opposing view to the proposed audit manual section which incorporates long-standing guidance (annotation 120.0524) that the electronic transfer of software coupled with the transfer of a dongle is subject to tax.

Staff advised the interested party that if there are fact patterns and circumstances in today's industry which differ from the fact pattern for which the annotation is based, staff is open to receiving information and can provide guidance related to those transactions. (Section 0421.06.)

- **Hierarchy of Evidence** – Interested parties suggested that staff's review of claimed nontaxable transactions should be based on a hierarchy of evidence. If the first level (sales invoice) does not demonstrate that the transaction is nontaxable, staff should review next level (purchase order) and so on. Staff's review should stop once a level of hierarchy shows a nontaxable transaction.

Staff does not believe a hierarchy of evidence is necessary. Since the records maintained may differ from one taxpayer to the next, placing an emphasis on one source document over another may create unintended consequences. Also, a hierarchy of evidence could potentially limit an auditor's judgment and the access to records.